

TABLE 12. (Continued)

Taxpayers Experiencing a Tax Increase			All Taxpayers	
Number of Returns (in thousands)	Total Increase in Income Class (in millions of dollars)	Average Increase for Affected Taxpayers (in dollars)	Net Tax Change (in millions of dollars)	Net Change from Credit Without Cap (in millions of dollars)
a	a	0	-67	-67
a	a	0	-631	-631
3	a	15	-679	-680
295	22	75	-576	-582
2,466	328	133	-351	-493
7,219	3,039	421	2,904	2,300
2,245	2,897	1,291	2,892	2,301
335	828	2,475	828	639
70	248	3,563	248	186
12,632	7,363	583	4,568	2,974

SOURCE: Treasury Tax Calculator, 1981 Tax Law at 1981 income levels.

a. Less than 0.5.

Eliminating Mortgage Interest or Property Tax Deductions for Second Homes

Another option the Congress could consider to focus more of the subsidy on those with the greatest need would be to eliminate the deductibility of home mortgage interest or property tax payments on second homes. Under this option, taxpayers would be allowed to deduct only interest or property tax payments for mortgages on their primary residences. Thus, these expenses for vacation homes and secondary residences would no longer be a deductible expense.

Limiting the deductibility of mortgage interest or property tax payments to a taxpayer's primary residence could eliminate some tax benefits for households with multiple homes, a group that includes mostly higher-income taxpayers. The revenue savings from this change might be small, however, for two reasons. First, property tax payments on vacation homes represent only a small part of total property tax payments, so the net revenue gain from eliminating the deductibility of this item would be fairly low--probably not more than \$250 million in fiscal year 1982.¹¹ Second, many vacation homeowners have other assets against which they could borrow, including unused equity in their primary residences, if mortgage interest deductions were limited to a taxpayer's primary residence. Thus, many owners of multiple homes might simply replace vacation-home mortgages with loans against business assets or second mortgages against their primary residences if deductions for mortgage interest payments on second homes were disallowed. Restrictions against using business assets for nonbusiness borrowing or second mortgages for other homes would limit this effect, but such restrictions might not be altogether effective. These same dangers, of course, exist for limiting home mortgage deductions in general, but owners of multiple homes are

11. The 1979 Annual Housing Survey indicates that about 4.9 percent of all homes are seasonal units and homes held for occasional use, while a 1969 Forest Service study suggests that vacation homes cost, on average, about half of what primary residences do, and that 5 percent of these homes are rented out. If these figures apply to property tax payments, then the share of the current tax expenditure for the property tax deduction on second homes should be about \$250 million in fiscal year 1982: \$10,705 million x 0.049 x 0.50 x 0.95 = \$249.2 million.

far more likely to be upper-income households with other assets to which home mortgage loans could be shifted.

If owners of multiple homes did not shift their loans to circumvent a deductibility prohibition, limiting deductible interest payments to those for a primary residence could increase federal revenues by \$500 to \$750 million in fiscal year 1982. The likely revenue effect of this proposal, however, seems far less--possibly as low as \$100 to 200 million, because of the opportunity for owners to shift mortgages.

Targeting More Benefits on First-Time Homebuyers

A third option for retargeting benefits would be to concentrate more tax savings on first-time homebuyers. As discussed in the previous chapter, the interaction of existing benefits with inflation and fixed-rate mortgages has helped house prices to rise much faster than the inflation rate, providing windfall gains to existing owners but making it harder for first-time homebuyers to finance a home than was true during the early 1970s. Since tax benefits were partly responsible for these increases, the Congress might want to provide some compensation to those who were disadvantaged.

Similarly, the Congress may want to provide special treatment for first-time homebuyers if it decides to limit or reduce existing tax benefits for homeownership. For example, if a ceiling is placed on home mortgage interest deductions, a higher limit might be applicable to first-time buyers for a specified time period. Other, more extensive options are also available, including the creation of tax-subsidized savings accounts, the provision of tax credits, and the promotion of alternative mortgage instruments that impose lower costs on buyers during the early years of ownership.

Establishing Tax-Subsidized Savings Accounts for First-Time Homebuyers (IHAs). One option that could assist first-time homebuyers would be to establish tax-subsidized savings accounts for this purpose, called "individual housing accounts" or IHAs. These accounts, which would operate similarly to individual retirement accounts, would permit prospective homeowners to deposit a maximum amount of money into a savings account whose balance could be used only toward the purchase of a first home. As with the IRAs, annual contributions to the account would be either tax-deductible or would qualify for tax credits, while interest earnings would be tax-free. Unlike IRAs, however, account balances would probably be

limited to a maximum size. One such proposal would allow taxpayers to contribute and deduct from their taxable incomes \$1,500 a year for 10 years to a tax-free housing account with a limit on total contributions of \$15,000. Married couples filing jointly could contribute up to \$3,000 a year, with a maximum balance of \$30,000, under this proposal.¹²

IHAs would help first-time buyers by enabling them to accumulate a down payment more quickly than would otherwise be possible. For example, a married couple in the 40 percent tax bracket who invested \$3,000 in an IHA paying 11 percent interest could receive tax benefits totalling about \$1,340 under the IHA plan described above, thus increasing the value of their savings by nearly 42 percent.¹³ Thus, IHAs would be a good vehicle to help persons who can accumulate savings toward buying a home.

A major drawback with IHAs as a way of enabling more families to afford a home is that their benefits would not be well-targeted on those most in need of assistance. IHAs would provide tax savings to those who can accumulate substantial savings toward a first home. This group is more likely to include higher-income taxpayers than it is the less-affluent households for whom high prices and interest rates have made affording a home particularly difficult. Under many IHA plans, benefits would be even more strongly directed at high-income households because contributions

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12. See S. 24, introduced by Senator Dole of Kansas, which would also create special, tax-subsidized savings accounts to pay for college expenses.
 13. With the IHA plan described above, the couple could receive \$1,200 in tax benefits from its \$3,000 in contributions. In addition, it could receive up to an additional \$139.51 in interest earnings, because interest on the account would no longer be taxable. Annual interest earnings on \$3,000 at 11 percent, compounded daily, would be \$348.78 after taxes, versus \$209.27 (60 percent of \$348.78) if the earnings were taxed; $\$348.78 - \$209.27 = \$139.51$. If these tax benefits were also saved, the couple's savings could equal \$4,548.78 ($\$3,000 + \348.78 in after-tax interest + \$1,200 in tax savings from the deposits) versus \$3,209.27 if the funds were deposited at the beginning of the year in a taxable account paying the same interest rate ($\$3,000 + \209.27), or almost 42 percent more ($\$4,548.78 \div \$3,209.27 = 1.417$).

to an IHA would qualify for a deduction from taxable income, rather than a tax credit. Deductions and exclusions from taxable income provide greater savings to taxpayers in high marginal tax brackets, and high-income taxpayers are generally in higher tax brackets than are those with lower incomes.

IHAs also have defects as a way of encouraging personal savings, because the high-income taxpayers that they are most likely to benefit are also the ones with the greatest incentives to buy a home using the smallest possible down payment, thus maximizing their mortgage interest deductions. The tax advantages of IHAs would be substantial enough that many of these higher-income taxpayers would still set up IHAs, since these would be better savings vehicles for accumulating a down payment than other financial investments. But IHAs would then simply be displacing saving that would take place in other forms, rather than providing an incentive for new saving.

IHAs would also have a high budgetary cost. CBO estimates that the establishment of IHAs along the lines of the proposal described earlier, effective January 1, 1982, could reduce federal revenues by about \$300 million in fiscal year 1982, \$5.7 billion in fiscal year 1983, and \$7.8 billion annually by fiscal year 1984. IHAs could thus absorb much of the revenue gains from a \$5,000 ceiling on deductible home mortgage interest payments (see Table 9).

Providing Limited Tax Credits for First-Time Homebuyers. Another way to concentrate more tax benefits on first-time homebuyers would be to provide them with limited tax credits based on the purchase price of the unit. First-time buyers, for example, might be given a one-year tax credit equal to 5 percent of the purchase price, with a maximum credit of \$2,500. This sort of credit, which is similar to one that was available for all homebuyers for most of the years 1975-1976,¹⁴ might cost between \$2.5 billion and \$4.0 billion at fiscal year 1982 levels if the number of first-time homebuyers ranged from 1 million to 1.6 million, as it has in recent years.

14. See 26 U.S.C. §44 (1975). This provision authorized a 5 percent tax credit for the first \$40,000 of house price for most home purchases between March 12, 1975, and December 31, 1976.

A flat-rate tax credit for first-time homebuyers would be more effective than an IHA proposal at reaching families who face great difficulties in becoming homeowners, because it would benefit those who cannot accumulate significant savings and would provide the same rate of subsidy to homebuyers at all income levels. Like IHAs, however, much of the tax savings would reach those who could afford a home anyway, unless the credit was limited to taxpayers with incomes below a certain level. This could be done, for example, by phasing out the credit as income reached a target figure. A further problem with tax credits is that they could raise prices for so-called "starter" homes, thereby reducing their effectiveness as subsidies. In addition, like IHAs they could aggravate the problem caused by the existing provisions affecting homeownership unless paired with a significant reduction in current tax benefits.

Promoting Mortgage Instruments with Low Early-Year Costs. If the Congress wants to assist first-time homebuyers without providing substantial new tax benefits, one option would be to encourage the use of mortgage instruments that require lower down payments or impose lower monthly payments during the early years of ownership. These types of mortgage instruments, which include graduated payment (GPMs) and shared appreciation (SAMs) mortgages, as well as conventional, fixed-interest rate mortgages with longer terms and lower down payments, reduce the cash-flow problems normally incurred by first-time homebuyers during a period of significant inflation.¹⁵ Many analysts believe that these cash-flow problems, rather than any fundamental decrease in the ability to afford a home, are the real barrier facing first-time homebuyers in periods like the present.¹⁶

Of the many ways to encourage the use of alternative mortgage instruments that would favor first-time homebuyers, perhaps the

15. For a further discussion of alternative mortgage instruments, see Appendix B.

16. See, for example, William Poole, "Housing Finance under Inflationary Conditions," in Federal Reserve Board Staff Study, Ways to Moderate Fluctuations in Housing Construction (Washington: Board of Governors of the Federal Reserve System, 1972), pp. 355-75; and J.R. Kearl, "Inflation, Mortgage and Housing," Journal of Political Economy, vol. 87 (October 1979), pp. 1115-39.

most effective would be a general increase in the supply of mortgage credit. Federal regulations now enable federally-insured savings and loans to issue 5 percent down-payment, 40-year conventional mortgages, in addition to graduated-payment, variable-rate, and shared-appreciation mortgages.¹⁷ Thus, the major obstacle to their use appears to be the reluctance of lenders to provide these loans--a reluctance encouraged by the high interest rates lenders must pay to obtain funds and the need to ration credit among current borrowers. Future inflows of additional mortgage money might increase the willingness of lenders to provide mortgage loans on more favorable terms. On the other hand, with substantial pent-up demand for housing and with lenders' net worth already lowered by the large stock of outstanding, low-interest-rate mortgages, a very substantial influx of funds would be needed for lenders to find it profitable to issue such mortgages. Such an increase seems unlikely if interest rates remain at very high levels.

Another option that would address particularly the reluctance of lenders to make graduated payment loans would be to count as taxable income only the cash payments received from these loans. This would represent a change from current law for the many lenders who are "accrual" taxpayers, because they would no longer be taxed on the "negative amortization" from graduated payment mortgages, although they have a right to receive this income.¹⁸ As such, it would represent a departure from the normal tax treatment of constructively-realized income.

Changing the tax treatment of graduated payment mortgages in this way would increase the effective rate of return on these loans, because lenders would no longer be taxed in the present on mortgage payments actually received in later years. Whether this change would have much effect on the supply of GPMs is uncertain, however, because lenders still might find it more profitable to offer other loans requiring level payments at any given interest rate.

17. See "Revision of Real Estate Lending Regulations," Federal Register, vol. 45 (November 18, 1980), pp. 76095 ff., esp. 76095-97 and 76099, affecting 12 CFR §545.6.

18. Current law makes taxable both cash payments and "negative amortization"--the amount by which payments fall short of paying off a loan and thus increase the actual mortgage balance. See IRS Revenue Ruling 77-135, Cum. Bull. 1977-18 (May 2, 1977), affecting 26 CFR §1.466-1.

APPENDIXES

APPENDIX A. FEDERALLY-CHARTERED AGENCIES AND DIRECT EXPENDITURE PROGRAMS THAT PROMOTE HOMEOWNERSHIP

In addition to the tax benefits described in this report, the federal government charters and, in some cases, funds through direct expenditures a number of agencies that promote homeownership. Some of these agencies provide loan guarantees and other services so that homebuyers can obtain more favorable mortgage loans. Others regulate and expand the supply of funds for home mortgage lending. Six of these agencies and their programs are described briefly in this appendix: the Federal Housing Administration (FHA), the Veterans Administration (VA), the Federal Home Loan Bank System (FHLBS), the privately-owned Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), and the Federal Home Loan Mortgage Corporation (FHLMC).

LOAN GUARANTEES AND RELATED SERVICES

The federal government funds two major insurance activities to provide homebuyers with more favorable mortgage loans: the mortgage insurance and graduated payment mortgage programs of the Federal Housing Administration (FHA) and the mortgage guarantee and direct loan programs of the Veterans Administration (VA).

Federal Housing Administration (FHA)

The Federal Housing Administration (FHA), founded in 1934, provides a number of services designed to promote homeownership. The best known of these is the FHA mortgage insurance program, a self-financing activity under which the federal government guarantees 100 percent of all qualifying mortgage loans in return for a lender's offering certain lending terms favorable to borrowers. Another FHA activity that has gained prominence recently is its promotion of graduated payment loans through the Section 245 program.

In recent years, the share of FHA-insured home mortgages has declined significantly, to between 10 and 15 percent of all new home mortgages, because of the growth of private mortgage insurance

and the gradual acceptance of low-down-payment, long-term-amortized mortgage loans. During fiscal year 1981, the FHA is authorized to commit nearly \$34.2 billion in mortgage loan guarantees.

Veterans Administration (VA)

Since the enactment of the GI Bill following World War II, loan guarantees and direct mortgage loans have been among the most popular services offered by the Veterans Administration. VA loan guarantees are normally limited to the lesser of 60 percent of the mortgage or a specified dollar amount, now set at \$27,500. Because the guarantee normally exceeds the loss from foreclosure for all except relatively expensive homes, many VA loans require little or no down payment. During fiscal year 1981, the VA is expected to guarantee an estimated \$10.5 billion worth of new home mortgage loans. For fiscal year 1982, the total is expected to reach \$11.2 billion.

REGULATION AND EXPANSION OF MORTGAGE LENDING

Four other federally-sponsored organizations serve to regulate and expand the volume of home mortgage lending in the United States: the Federal Home Loan Bank System (FHLBS), the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), and the Federal Home Loan Mortgage Corporation (FHLMC). Each of these institutions promotes these objectives in a somewhat different way.

Federal Home Loan Bank System (FHLBS)

The Federal Home Loan Bank System (FHLBS), consisting of a Federal Home Loan Bank Board (FHLBB) and 12 regional home loan banks, performs many of the same activities for federally-insured savings and loan (S&L) associations that the Federal Reserve System undertakes for commercial banks. The FHLBS monitors savings and loan activities, advancing money to S&Ls in need of additional funds. The FHLBB regulates all savings and loan deposit and lending activities of federally-insured S&Ls. Thus, it determines what types of loans and deposits S&Ls may offer.

Federal National Mortgage Association (FNMA)

The Federal National Mortgage Association (FNMA), founded in 1938 and made a private corporation in 1968, is the oldest of the

federally-sponsored agencies providing additional funds for mortgage lending through the creation of a "secondary market" for mortgage loans. FNMA has traditionally served as a mortgage dealer, alternatively buying and selling mortgages to maintain the liquidity of the home mortgage market. Since the mid-1960s, however, FNMA has been required to purchase certain types of mortgages involving low- and moderate-income homebuyers, thus becoming a net holder of home mortgages. Although FNMA is authorized to borrow some funds from the federal government, its activities have thus far been financed solely by the sale of its own bonds.

Government National Mortgage Association (GNMA)

The Government National Mortgage Association (GNMA) was created in 1968 to assume some of the more specialized duties originally assigned to FNMA. Thus far, GNMA has performed two major tasks. One is to expand the secondary mortgage market by creating a new type of federally-insured security, the GNMA mortgage-backed security. The other has been to subsidize mortgage lenders, by purchasing below-market-rate mortgages at par and selling them at market value--what is called the GNMA "Tandem" plan. GNMA's Tandem activities are supported directly by federal appropriation; its mortgage-backed security activities are self-financing. In fiscal year 1981, GNMA is expected to increase its net commitments of mortgages by about \$650 million, while its guarantees for mortgage-backed securities are authorized to reach \$53 billion. The income from this last activity is expected to exceed expenses by about \$89.4 million.

Federal Home Loan Mortgage Corporation (FHLMC)

The Federal Home Loan Mortgage Corporation (FHLMC) is the newest of the federal mortgage assistance agencies. It serves to purchase mortgages directly from mortgage originators, primarily savings and loan associations. Founded in 1970, FHLMC has acquired over \$27.3 billion in mortgages and other loans receivable. Like FNMA and GNMA, it supports its activities by raising funds through the sale of low-rate federal bonds. FHLMC stock is owned by the regional home loan banks of the Federal Home Loan Bank System.

APPENDIX B. RECENT INNOVATIONS IN HOME MORTGAGE INSTRUMENTS

Significant changes in home financing have occurred in the last several years. In place of the traditional, level-payment, fixed-interest-rate mortgage, lenders and homebuyers have increasingly opted for a number of different mortgage instruments. Some of these provide lenders more protection against unexpected fluctuations in interest rates by allowing changes in the mortgage rate itself and corresponding alterations in monthly payments. Others permit buyers to afford more expensive homes by allowing mortgage payments to rise over the term of the loan in place of the constant, level payment. Still other mortgages allow homebuyers to reduce their monthly mortgage payments by giving lenders part of the increase in the value of their homes when they are later sold or after a specified time. Each of these new mortgage instruments represents a market response to the effects of inflation on house prices and interest rates. Nevertheless, certain obstacles may limit the spread of these new instruments. Following is a brief discussion of the major innovations in home mortgage finance and their potential hazards.¹

Major New Instruments and Their Hazards

Of the many new mortgage instruments that have become prominent during the last several years, the limited-adjustment variable rate mortgage (VRM), the renegotiable rate mortgage (RRM), the graduated payment mortgage (GPM), and the shared appreciation mortgage (SAM) have received the most attention. In addition to these three new instruments, the Federal Home Loan Bank Board (FHLBB) has recently liberalized mortgage lending rules for federally-insured savings and loan associations. Under these rules, S&Ls can now

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1. For more extended discussions of new mortgage instruments, see Rochelle L. Stanfield, "High Interest Rates are Sparking a Revolution in Home Financing," National Journal, vol. 13 (January 31, 1981), pp. 172-76; and Federal Home Loan Bank Board, Alternative Mortgage Instruments Study (November 1977).

make 40-year mortgage loans with down payments as low, in some cases, as 5 percent.²

Limited-adjustment "variable rate mortgages" are mortgages in which interest rates and monthly payments may change, based on changes in a predetermined index such as the Treasury bill rate, but not beyond certain limits. Under some mortgages of this type, the interest rate may only change by a limited amount during any time period; for example, some loans prohibit interest rate changes of more than 1/2 percentage point during any 12 months. Some loans also limit the total possible change in interest rates over the term of the mortgage. Other variable rate mortgages allow unlimited changes in interest rates but restrict changes in monthly payments to certain frequencies, such as every several years. Under one such plan, monthly payments remain fixed for five years, but any shortfall of payments from true obligations is used to increase the loan balance. This increase in the loan balance, called "negative amortization," is then used to determine the new set of monthly payments at the end of that five-year period.³

While variable rate mortgages protect lenders against interest rate fluctuations, they pass that risk on to borrowers. Many consumer groups have thus objected to VRMs, although likely consumer reactions to them will depend on economic conditions and the range of financing options available.

Renegotiable rate mortgages (RRMs) are another type of mortgage that allows interest rates to change during the term of the loan. With these loans, the lender can renegotiate the interest rate and monthly payments to reflect current conditions at specified intervals. Like VRMs, they let lenders offset the higher cost of funds when interest rates rise and the yields on long-term mortgages fall below current market levels. Their major difference from VRMs is that interest rates are changed only when the loan comes up for renegotiation. Like VRMs, RRMs have also been

2. See "Revision of Real Estate Lending Regulations," Federal Register, vol. 45 (November 18, 1980), pp. 76096 ff., esp. pp. 76096-97 and 76099, affecting 12 CFR §545.6.

3. See "Buyers Adrift: How Floating Rates Affect More Home Purchasers," Wall Street Journal (May 6, 1981), pp. 1, 20.

criticized by some consumer groups. In addition, some lenders have had to offer them at a discount to attract borrowers.⁴

Graduated payment mortgages (GPMs), pioneered by the U.S. Department of Housing and Urban Development (HUD) through the Section 245 housing program, are loans in which payments begin below the level of full amortization and then rise during the first several years until they reach a level where the balance can be fully paid by the end of the loan term. While payments are rising, the loan balance increases; this represents the negative amortization discussed earlier. These types of instruments can allow young families with prospects for income growth to afford larger mortgages than they otherwise might. They can create problems, however, if family incomes do not grow as anticipated. In addition, they provide lenders with greater risk and lower returns than do conventional mortgages at the same interest rate, because the negative amortization can be taxed even though no cash payments are received.

Shared appreciation mortgages (SAMs), the newest of the alternative mortgage instruments, provide borrowers with below-market interest costs in return for giving the lender a percentage of any increase in the price of a home. Under one type of SAM, borrowers receive a one-third reduction in interest rates in return for allowing the lender a one-third share in any rise in housing value at the date of sale or during the first ten years of ownership. This type of loan may prove advantageous to homeowners expecting large income gains or small increases in house prices. It can pose problems, however, if house price appreciation greatly exceeds the rise in the borrower's income. In addition, some critics fear it could lead to "redlining," because lenders would favor more affluent neighborhoods with greater chances of house price appreciation.⁵

4. See "Business Struggles to Market the RRM," Savings and Loan News, vol. 110 (July 1980), pp. 30-34.

5. See Kenneth R. Harney, "Criticized SAM Loans in Limbo," Washington Post (January 10, 1981), p. F10; and Stanfield, "High Interest Rates," p. 174. Lenders who did redline could incur penalties under the Community Reinvestment Act of 1977, 12 U.S.C. §§2901-2905 (1977).

